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July 19, 1996

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW, Room 222
Washington, DC 20554

RE: Ex Parte Presentation
CC Docket No. 96-45

Dear Mr. Caton:

Pursuant to the Commission staff's request, on July 19, 1996, Michael Hurst, Ted Hadley and I representing AT&T, met with Anthony Bush and Bill Sharkey of the Commission staff. At this meeting, we provided an analysis of the "Cost Proxy Model" that Pacific Bell has proposed for adoption in this proceeding.

Two copies of this Notice are being submitted to the Secretary of the FCC in accordance with Section 1.1206(a)(1) of the Commission's rules. Copies of the presentation materials used at this meeting are attached.

Sincerely,

Richard N. Clarke

Attachment

cc: A. Bush
W. Sharkey

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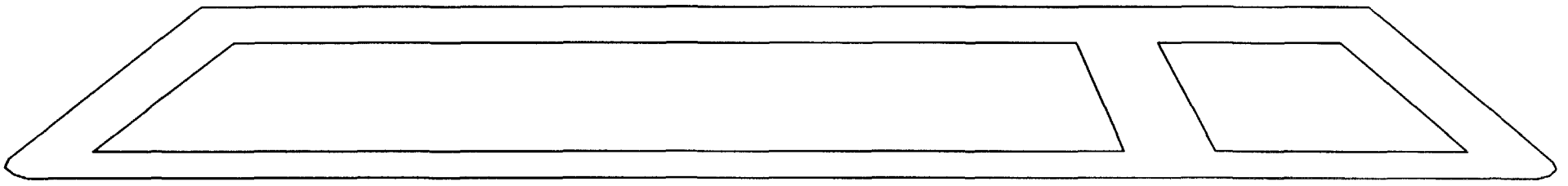
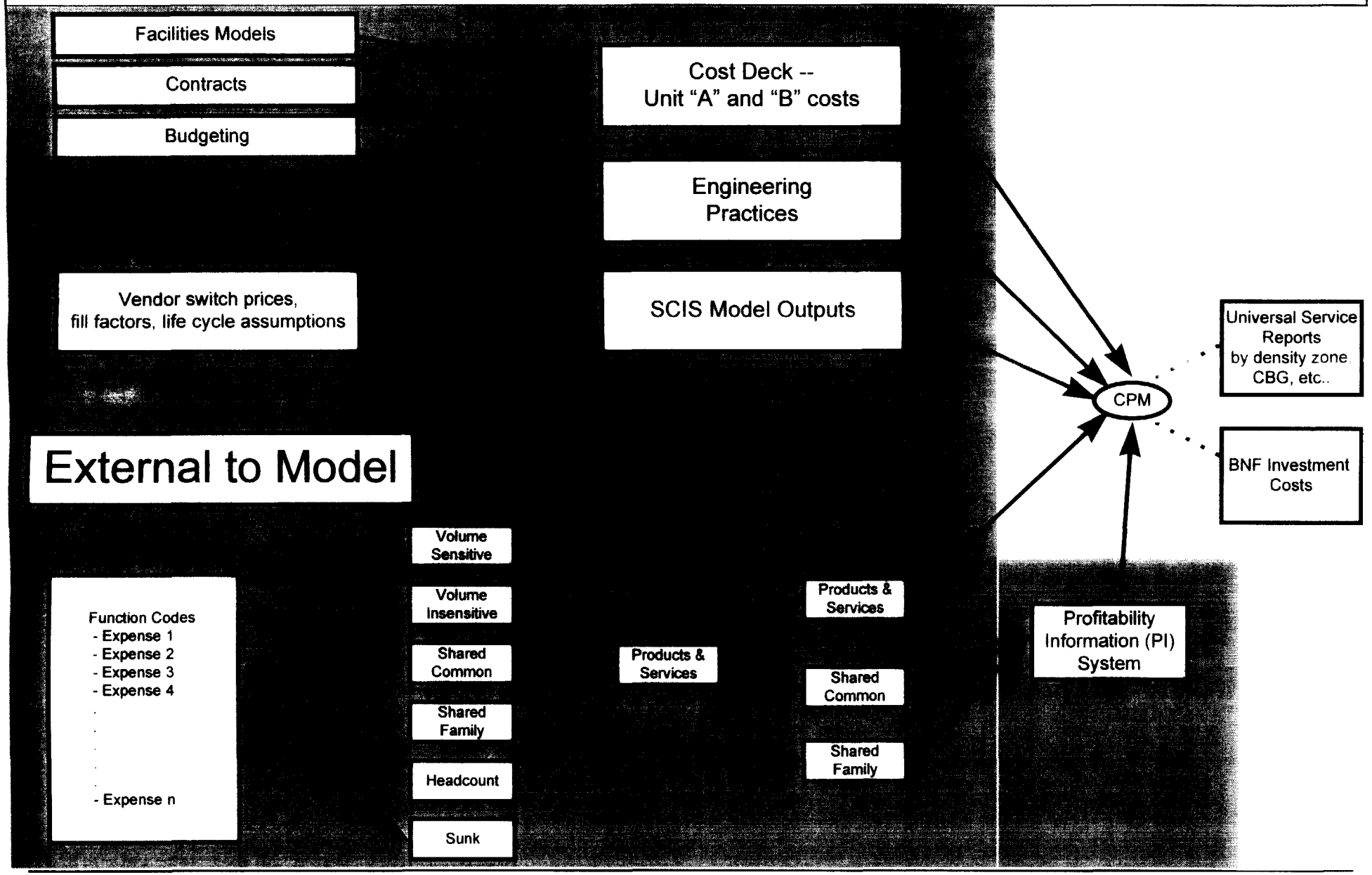
What's Wrong With The Cost Proxy Model



General Issues

- It's really several models (SCIS, Cost Deck, Facilities Models)
- California Specific
- Overbuilt System (Not POTS - Shows Up in Fill Factors)
- Use of Unitized Cost (Overstates Longer Loop Cost)
- Overpriced Facilities
- Wrong Technology
- Inflated and Miscategorized Expenses

Cost Proxy Model Analysis



Cost Proxy Model Analysis

- **California Specific**
  - **Pacific Bell is Expense Benchmark**
  - **Engineering Underpinnings Are Pacific Specific**

Cost Proxy Model Analysis

- **Overbuilt POTS System (expressed in low fill factors)**
  - **Anticipating Broadband Service**
  - **Anticipating Second Line Penetration Services**
  - **Anticipating Centrex Sales**
  - **Switching Capacity**

Cost Proxy Model Analysis

- **Use of Unitized Cost**
  - **Entire Investment Analysis Outside CPM**
  - **Overstates Cost of Longer Loops**
  - **Time-of-Day Distortions**

Cost Proxy Model Analysis

- **Overpriced Facilities**
  - **SCIS Switching Inputs**
  - **Historic Contract Analysis**
  - **Historic Budget Analysis**

Cost Proxy Model Analysis

- **Wrong Technology**
  - **NGDLC**
  - **Longer Loop Options**

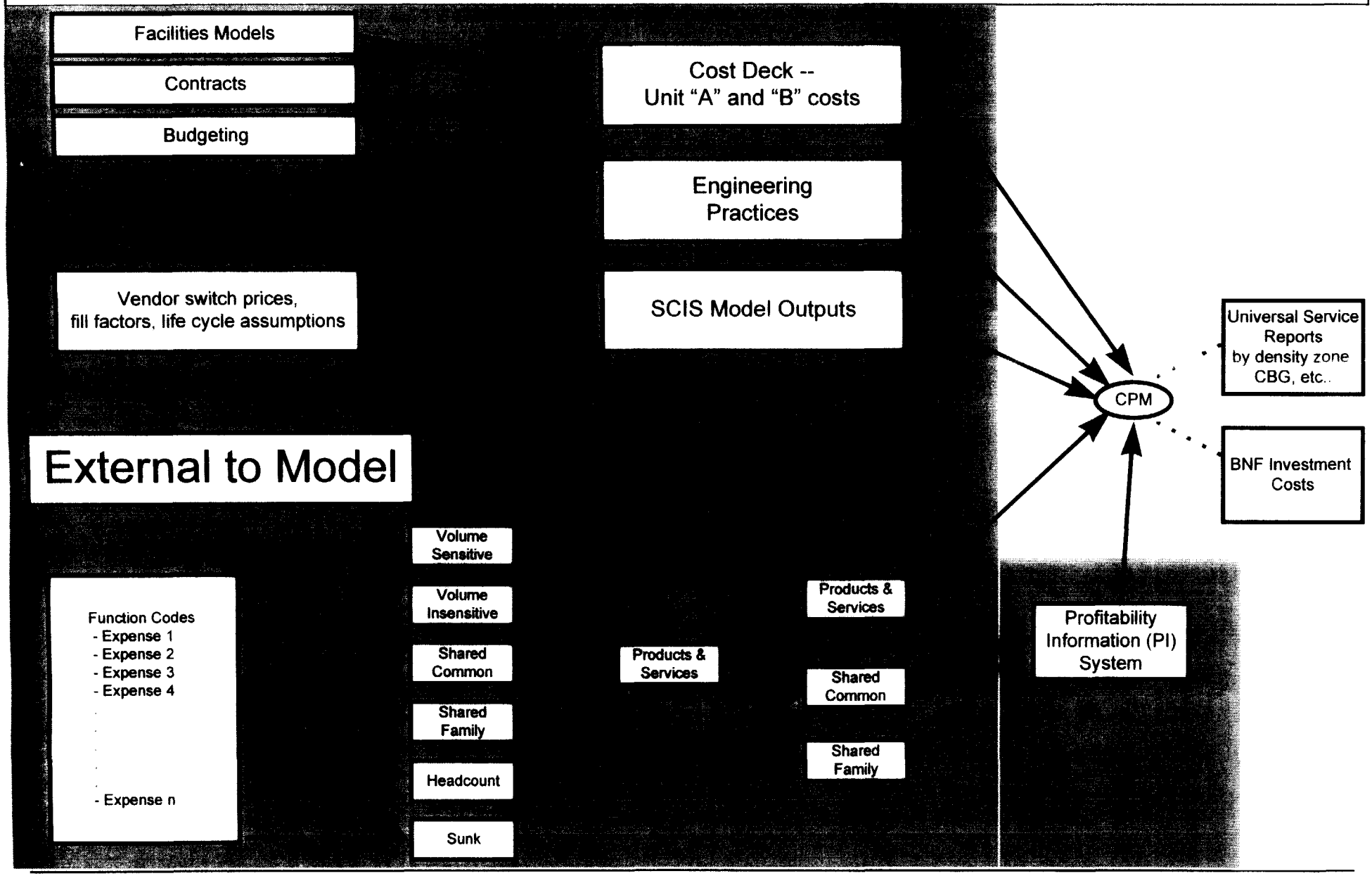
Cost Proxy Model Analysis

- **Inflated and Miscategorized Expenses**
  - **No Productivity or Efficiency Gain Adjustments**
  - **Huge Categories of "Shared" and "Common"**
  - **Exorbitant Non-recurring Cost**
  - **Arbitrarily Reduces Retail Related Expenses**

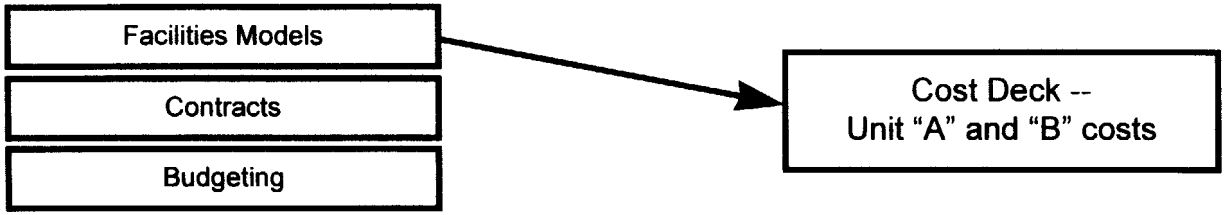
Implications

- **Universal Service**
  - Inflated Residential Loop Cost Estimates
  - Inflated Differential Between Urban and Rural
- **BNF Analysis**
  - High Unbundled Loop Cost
  - High Switching Cost
  - Arbitrary NTS vs. TS Switching Costs
  - Common/Shared Pricing Dilemma
- **Avoided Cost Analysis**
  - Common/Shared Exclusion Enormous
  - Retail Expenses Deflated

Cost Proxy Model Analysis



Cost Proxy Model Analysis



- **Cost Deck**
  - **Historically used as a unit cost source for initial overall project viability analysis**
- **Facilities Models**
  - **Used to develop Cost Deck values for fiber feeder, and copper feeder and distribution**
  - **"Engineering Constructs" designed to estimate the cost of plant placement activities given a range of cable sizes and lengths**
- **Contracts**
- **Budgeting**

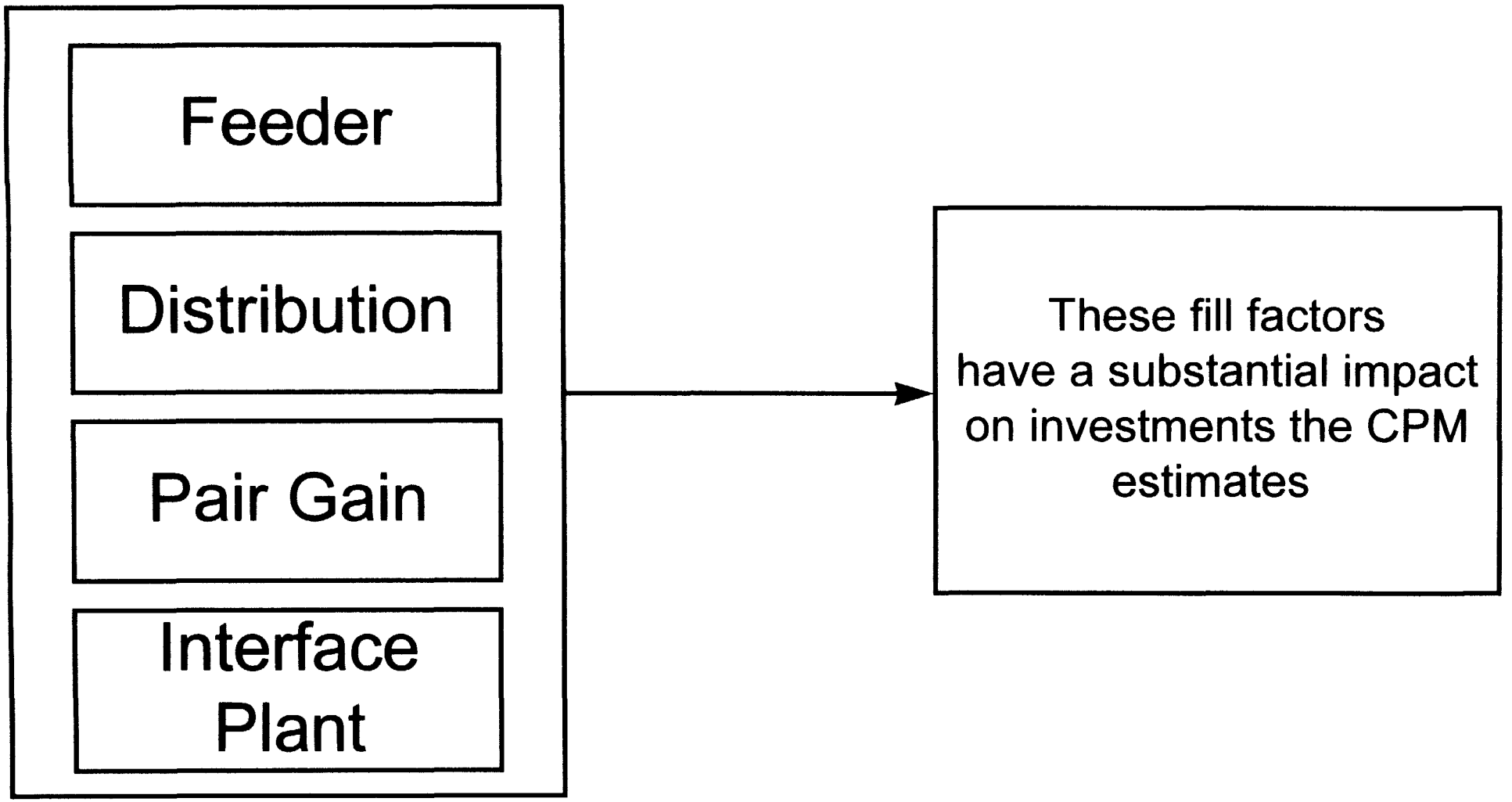
Engineering Practices

- **Long term practice of designing for digital and broadband — not POTS - Network in transition**
  - **1987 *Loop Planning Methods***
  - **1989 *Strategic Technology Transition Guidelines***
  - **1990 *Strategic Technology Transition Guidelines update***
  - **1993 *Loop Broadband Planning Guidelines***
  - **1994 *Stratified Loop Guidelines***

Engineering Practices

Network is designed in anticipation of digital and broadband	Investment incurred goes to POTS
Current utilization levels	Investment for growth and other services goes to POTS
9,000 foot crossover point	Investment made for broadband goes to POTS
Structure used to support cable, electric, competitors' facilities	All structure cost goes to POTS
All current plant locations are taken as fixed	The model merely reflects the result of Pacific's historical practices

Engineering Practices: Pacific's Chosen Fill Factors Are Unreasonably Low



Cost Proxy Model Analysis

- **Pacific's switching costs:**
  - **Fiber / copper differential**
  - **Algorithm differential by vendor**
  - **Do not reflect economies of scale**
  - **Life-cycle pricing**

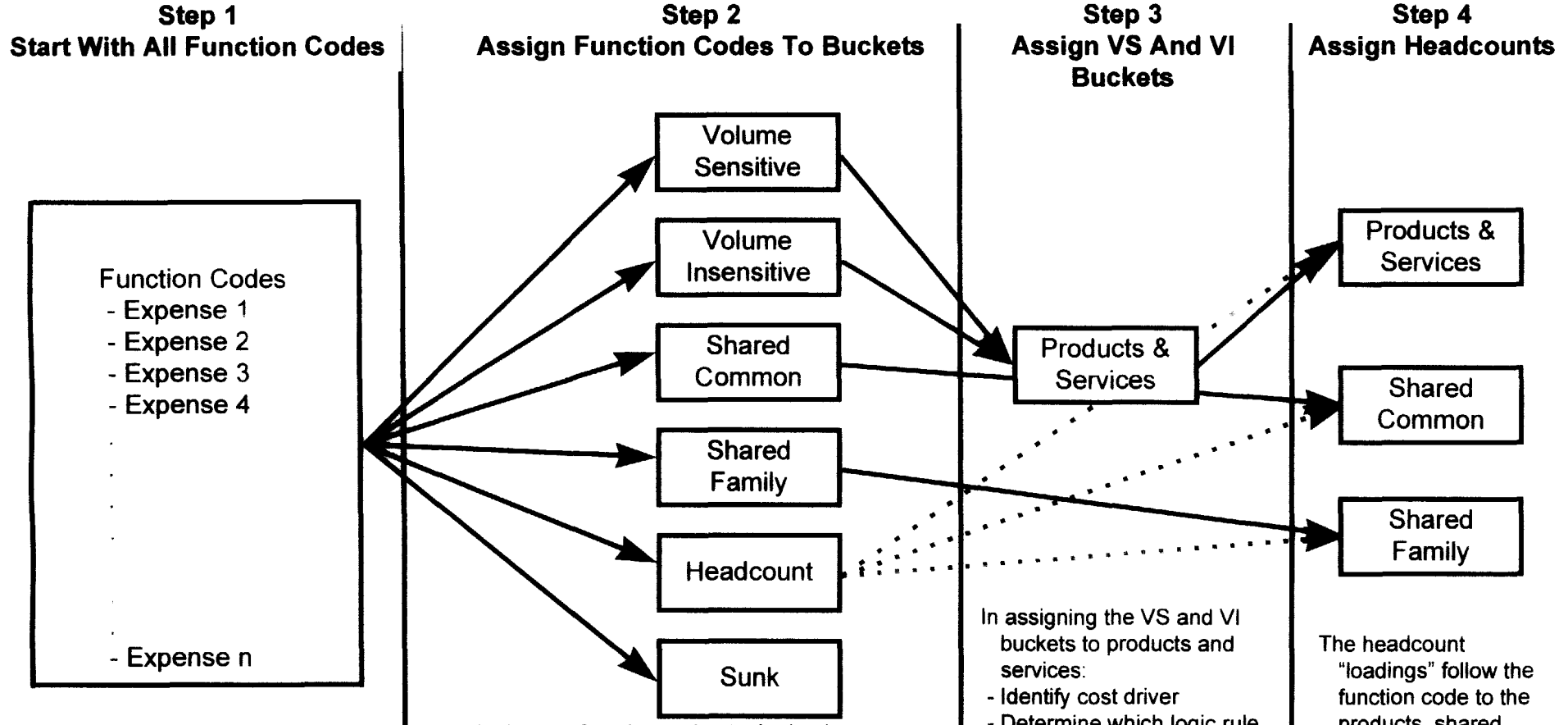
Investment Summary

- The unitized "A" and the "B" costs in Pacific's models are unverified and overstate the cost of longer loops
- The CPM reflects Pacific's chosen engineering practices, which are driven largely by Pacific's desire to furnish discretionary services
- Pacific inappropriately spreads the costs of a transition to broadband capacity through unreasonable low fill factors

Cost Proxy Model Analysis

- **Pacific applies the investment practices embodied in the CPM to other ILECs through:**
  - **unit costs**
  - **ratio of feeder to distribution**
  - **route to airline miles**
  - **mix of cables by density zones**
  - **placement of pair gain devices**
  - **fill factors**
  - **modification factors**

Pacific Overall OANAD Expense Identification Process



Unclear:
- Forward looking adjustments may be made at this stage of the function code analysis

In assigning the function codes to the buckets:
- Some function codes were assigned entirely to a single bucket
- Some function codes were split between buckets based on account description or SME judgment
- Exclude portion of expense that was associated with non-recurring activities

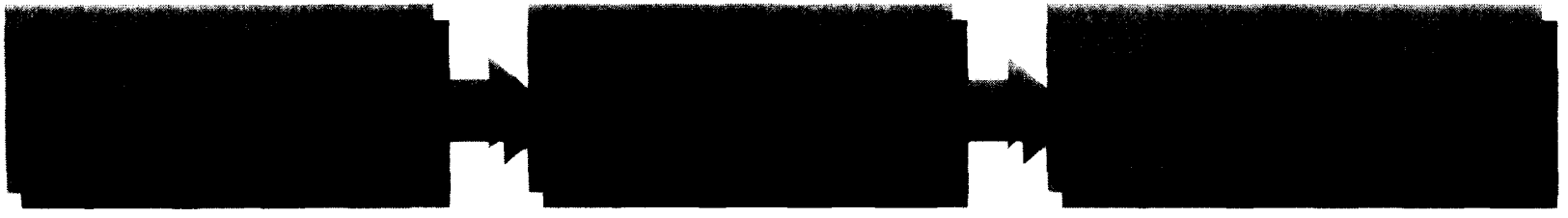
In assigning the VS and VI buckets to products and services:
- Identify cost driver
- Determine which logic rule applies to cost driver
- If no logic rule with the cost driver was available, a special study was developed to allocate based on "fixed proportion"

The headcount "loadings" follow the function code to the products, shared families, or shared common based on the logic rule that was applied to the function code

Investment Choices And Operations Improvements Are Not Captured In Pacific's Expense Identification Process

- Investment related expenses:
  - Rearrangement
  - Maintenance
- Operations improvement programs
- Non-Recurring Cost burden

Expense Identification Process



- **Three step process:**
  1. **Does the function code appear in only one family and is it at least 80% of the function code assigned to that family**
  2. **Identify how much of the function code that meets (1) are assigned to Universal Service products/services**
  3. **Divide the sum of (2) by the sum of (1) to determine an allocator for the entire family**

It's California Specific

- **Investment (System Engineering)**
  - Design Influences
  - Technology
  - Depreciation
- **Expenses**
  - Productivity
  - Oganizational Systems
  - Categorization